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IN THE

Supreme Court of the United States

OCTOBER TERM, 1957

No. 989

MONTE MANSFIELD and ELEANOR MANSFIELD, *Petitioners*,

v.

THE UNITED STATES, *Respondent*.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

LLOYD FLETCHER
983 National Press Building
Washington 4, D. C.
Attorney for Petitioners.

SCOTT P. CRAMPTON
934 Bowen Building
Washington 5, D. C.
Of Counsel.

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v.

THE UNITED STATES, *Respondent.*

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

The petitioners, Monte Mansfield and Eleanor Mansfield, pray that a writ of certiorari be issued to review the opinion and conclusion of law of the United States Court of Claims entered in the above-entitled cause on March 5, 1958.

OPINION BELOW

The opinion of the United States Court of Claims was filed on March 5, 1958, and is not as yet officially reported. A copy of this opinion is printed in the record herein as certified and transmitted to this Court (R. 41-60), and is also contained herein as Appendix B, *infra.*

GROUNDS ON WHICH THE JURISDICTION OF THIS COURT IS INVOKED

Petitioners began this suit in the United States Court of Claims to recover Federal income taxes alleged to have been erroneously overpaid by them for the calendar year 1951 (R. 1). The parties agreed to a severance of issues before a Commissioner of the United States Court of Claims (R. 19, 20). The principal legal issue was decided by the Court below against the contention of the petitioners in an opinion, findings of fact, and conclusion of law entered March 5, 1958 (R. 41). This petition is filed within the time allowed therefor under 28 U.S.C. Section 2101(c).

The jurisdiction of this Court is invoked under 28 U.S.C. Section 1255(1).

QUESTION PRESENTED

Where, in a non-taxable transaction, part of the assets of a corporation are transferred to another corporation in exchange for all the stock of such other corporation, which stock is then held by the transferor, should an allocation of the earnings and profits of the transferor be made for Federal income tax purposes as between the two continuing corporations?

STATUTES AND REGULATIONS INVOLVED

The statutes involved are Sections 112 and 115 of the Internal Revenue Code of 1939. The regulations involved are Treasury Regulations 118, § 39.115(a)-3. The pertinent provisions of these statutes and regulations are set forth in Appendix A, *infra.*

STATEMENT OF THE CASE

Prior to 1948 the petitioner, Monte Mansfield, operated a Ford automobile agency in Tucson, Arizona, as a sole proprietor (Fdg. 2, R. 52). As of January 1, 1948, petitioners formed a corporation for the conduct of this busi-

ness and transferred to it the Ford agency operation and also the land and building in which the business was conducted (Fdg. 3, R. 52, 53). In exchange for these assets petitioners received substantially all of the stock of the corporation (Fdg. 3, R. 52, 53).

At the time of the formation of this corporation, the land and building so transferred to it had a book value of $202,162.26, subject to a mortgage of $67,500.00. The equity in such real property accordingly amounted to $134,662.26 (Jt. Ex. 2, R. 35). The corporation upon its organization agreed to pay certain pending liabilities of petitioners including their 1947 Federal income taxes (Jt. Ex. 1, R. 33). The net value of the assets over these liabilities was $126,008.49, and petitioners received stock of the corporation in the par value of $126,000.00 (Jt. Exs. 1 and 2, R. 33-35).

During the first year of operation by the corporation an addition to the aforesaid building was completed, and the property was refinanced on July 21, 1948. At that time a new mortgage was placed on the property in the amount of $140,000.00 to cover the cost of constructing the building addition and to supply operating capital for the Ford agency business. (Jt. Exs. 4 and 5, R. 38-40).

As a result of its first year of operation the corporation had earnings of $60,138.94 and had an earned surplus, after the payment of Federal income taxes and certain other non-deductible items, of $31,336.92 (Fdg. 5, R. 53; P's Ex. A, R. 26-27). At the end of 1948 the land and building had a book value of $160,878.51, were subject to a mortgage of $136,296.64, and the equity remaining in the said real estate was therefore $124,581.87 (Jt. Ex. 2, R. 35).

As of January 1, 1949, all operating assets of the Ford agency were transferred to a new corporation known as Monte Mansfield Motors in exchange for 312 shares of its capital stock. (Fdg. 6, R. 53). The corporation which had

operated this business during 1948 continued in existence under the name Monte Mansfield Investment Company. (Fdgs. 3, 6; R. 53). Its only assets, other than the stock of the Motors Company, were the land and building (including prepaid insurance thereon) which it thereafter rented to the new operating company. (Fdg. 9, R. 54-55).

This corporate division at the end of 1948 was treated by the parties as a non-taxable transaction (Fdg. 8, R. 53). In connection with this division of corporate assets and liabilities, no allocation was made in the accounting records of the two corporations of earnings and profits which had been earned by the Investment Company during 1948 (Fdg. 7, R. 53).

As of July 1, 1951, the transferor corporation, Monte Mansfield Investment Company, was liquidated under the provisions of Section 112(b)(7) of the Internal Revenue Code of 1939 (Fdgs. 13, 14; R. 56-57). In exchange for their stock in the Investment Company, the petitioners received the land, building, and other assets of the transferor Investment Company, including the 312 shares of stock of the transferee, Monte Mansfield Motors. (Fdgs. 13, 14; R. 56-57).

Petitioners reported the transaction as a non-taxable exchange under said Section 112(b)(7) and included in income only the earned surplus of $1,572.37 which had been realized by the transferor corporation, Investment Company, between January 1, 1949, and the time of its liquidation at July 1, 1951 (Fdgs. 10, 14; R. 56-57).

Upon examination of the 1951 income tax return filed by petitioners the Commissioner of Internal Revenue determined a deficiency by including in income the entire 1948 earned surplus referred to above, amounting to $31,336.92 (Fdg. 18, R. 59).

The asserted deficiency was paid by petitioners and a claim for refund was filed (R. 6, 10). When the Commis-

sioner of Internal Revenue failed to allow the claim, this action was commenced in the Court of Claims pursuant to the provisions of 28 U.S.C. Section 1491.

REASONS FOR GRANTING THE WRIT

Since the decision in *Commissioner* v. *Sansome*, 60 F. 2d 931, (C.C.A., 2d, 1932), certiorari denied 287 U.S. 667, it has been established tax law that an allocation of accumulated earnings and profits should be made where part of the assets and liabilities of one corporation are transferred to another corporation in a non-taxable reorganization.

This rule has been repeatedly set forth in the Treasury Regulations covering a period of 20 years and has been cited with apparent approval by this Court in *Commissioner* v. *Phipps*, 336 U.S. 410, 415 (1949), and *Commissioner* v. *Munter*, 331 U.S. 210 (1947). It has also received explicit Congressional approval. See Senate Report No. 2156, 74th Cong., 2d Sess., p. 19 and Senate Report No. 1622, 83rd Cong., 2d Sess., p. 250.

1. At page 11 of its opinion the Court of Claims holds that:

> * * * we would limit the application of the *Sansome* rule to cases in which the facts are identical or closely analogous with those in the *Sansome* case, i.e., where *all* of the assets and liabilities of the old corporation are transferred to the new corporation and where the old corporation is liquidated simultaneously with or as a part of the same transaction. (R. 51; Court's Italics)

In so holding that the *Sansome* rule should be limited strictly to the facts of that case, the decision below presents a conflict with the case of *Reed Drug Co.* v. *Commissioner*, 130 F. 2d 288 (C.C.A. 6th, 1942) and conflicts in principle with numerous other decisions applying the *Sansome* rule. See *Robinette* v. *Commissioner*, 148 F. 2d 513 (C.C.A., 9th, 1945); *Harter* v. *Helvering*, 79 F. 2d 12

(C.C.A., 2d 1935); *Barnes* v. *United States,* 22 F. Supp. 282 (E.D., Pa. 1938); *Stella K. Mandel,* 5 T.C. 684; and *Estate of Howard H. McClintic,* 47 B.T.A. 188.[1]

2. The decision below involves an important question of Federal tax law which has not been, but should be settled by this Court. Similar situations will occur in future corporate reorganizations. The importance of the question is demonstrated by the large number of cases applying the *Sansome* rule in varying situations and also by the many articles discussing the general subject matter.[2] It is submitted that the problem is a recurring one in the administration of the Federal tax laws and therefore should be affirmatively and finally disposed of by this Court.

3. A subsidiary point believed to be involved is the failure of the Treasury Department in this case to follow its own applicable regulations. By approving in effect, the action of the Treasury Department in this regard, the decision below fails to follow *Service* v. *Dulles,* 354 U.S. 363 (1957) and *United States ex rel. Accardi* v. *Shaughnessy,* 347 U.S. 260 (1954). In this respect the decision below also conflicts with *McKay* v. *Wahlenmaier,* 96 U.S. App. D.C., 313, 321, 226 F. 2d 35, 43 (1955), and *McCord* v. *Granger,* 201 F. 2d 103, 106 (C.C.A., 3d, 1952), thus adversely affecting one of the fundamental principles of administrative law, i.e., that the Government and its citizens alike are bound by the terms of a valid regulation.

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[1] These cases have all been cited by this Court with apparent approval in *Commissioner* v. *Phipps, supra.* See Footnotes 6 and 10, 336 U.S. 415, 416.

[2] A number of the authorities are collected at Mertens, Law of Federal Income Taxation, § 9.52.

ARGUMENT

1. The decision below creates a conflict

The conflict between the decision below and other decisions applying the *Sansome* rule is brought into sharp focus by consideration of *Reed Drug Co.* v. *Commissioner*, *supra*. There a parent corporation, in the summer of 1937, transferred all its assets and liabilities to a newly formed subsidiary corporation in exchange for all of the latter's capital stock. Thereafter, prior to the end of 1937, the parent corporation was liquidated and, as here, distributed to its stockholders its shares of stock in the subsidiary. The parent had an accumulated earned surplus, and it claimed a "dividends paid credit" on the theory that in liquidation it had distributed such earned surplus to its stockholders. However, the Sixth Circuit Court of Appeals refused the credit and held, in the words of the Court of Claims below,

> * * * that the earnings and profits of the parent corporation had gone to the surviving subsidiary corporation *six months prior to the parent's liquidation, at the time of the exchange*, citing *Sansome*. (R. 49; Op. 9; Italics Supplied).

In attempting to distinguish the *Reed Drug* case from the instant case, the Court of Claims stated that

> * * * in the *Reed* case, the court found that, for all practical purposes, the liquidation of the parent corporation was part of the same transaction and simultaneous with the transfer of *all* of its assets and liabilities. (R. 49; Op. 9; Court's Italics).

Counsel for petitioners, however, have been unable to locate a finding by the court in the *Reed Drug* case that the reorganization and liquidation there involved were a "part of the same transaction and simultaneous with the transfer of *all* of its assets and liabilities." As already noted, a number of months in fact intervened between the reor-

ganization and liquidation. In cases of this type, the time element has never been thought crucial to the application of the *Sansome* rule. See, for example, *Estate of Howard H. McClintic, supra,* where the *Sansome* rule was applied to a series of "split-off" reorganizations even though the liquidation of the original corporation occurred some *four years* after the reorganizations. In this same connection, see Ohl, "Basis and Allocation of Earnings and Profits in Spin-Off, Split-Off and Split-Up Reorganizations," N.Y.U. 11th Ann. Inst. on Fed. Taxation, p. 311 (1953) where the author states at p. 339:

> Although this case (*Sansome*) involved a reorganization in which the transferor corporation disappeared, the rule, as currently embodied in the regulations, applies equally to tax-free reorganizations where the transferor remains alive.

The court below also distinguishes the *Reed Drug* case on the ground that there "*all* of the parent's assets and liabilities were transferred to the subsidiary at the time of the exchange . . ." (R. 49; Op. 9; Court's Italics). While this was true in the *Reed Drug* case, as in the *Sansome* case, it hardly warrants the holding by the Court of Claims below that the application of the allocation rule will be limited by that court to cases where *all* assets and liabilities of the old corporation are transferred to the new corporation.

In *Commissioner* v. *Phipps, supra,* this Court has stated its understanding of the application of the *Sansome* rule as follows:

> The rule that earnings and profits of a corporation do not lose their character as such by virtue of a tax-free reorganization or liquidation has been applied where more than one corporation has been absorbed or liquidated, *where there has been a 'split-off' reorganization,* and where the reorganization has resulted in substantial changes in the proprietary interests. 336 U.S. 416 (Italics Supplied)

The limitation of the *Sansome* rule by the court below is also at odds with the understanding of that rule by other courts. This is perhaps best illustrated by the analytical rejection of the same argument in *Estate of Howard H. McClintic, supra,* where the Board of Tax Appeals stated at 47 B.T.A. 200, 201:

> While accepting the doctrine of the *Sansome* case when applied to a complete transfer which leaves the predecessor corporation without assets, petitioners resist its application if the transferor retains property which is sufficient to cover the amount of its undistributed earnings . . .
>
> Our doubt as to the correctness of this claim can be briefly illustrated. Suppose a corporation desires to get accumulated earnings into the hands of its stockholders without subjecting them to the tax on dividends. If petitioners are correct all that would be required would be for the old corporation to transfer assets to a new one, equivalent to the amount of the proposed distribution, and distribute to its stockholders the new company's stock, which would be both tax-free . . . and expressly precluded from affecting the subsequent distribution of earnings. If the principle of the *Sansome* case does not govern, as petitioners urge, *because the old corporation has transferred only a part of its assets,* then the argument of the taxpayer in the *Sansome* case, which was rejected there, would now become valid with the result that a distribution by the new corporation would be considered a payment from its capital and hence not a taxable dividend. And this process could be repeated as many times as the old corporation desired to organize a new company to acquire its most recently accumulated earnings instead of declaring any dividends itself, at least until the shareholders had thereby recovered the cost of their shares. (Italics Supplied)

To the same effect, and likewise involving a transfer in a "split-off" reorganization of only part of the assets, see *Barnes* v. *United States, supra* and *Stella K. Mandel, supra.* The long standing and generally accepted rule has

been aptly summarized in the New York University article cited above, at page 339, as follows:

> If the stock of the transferee is received without payment of a dividend tax, as in a tax-free spin-off the rule requiring allocation of a portion of the transferor's earnings and profits to the transferee applies *even though the transferor retains assets in an amount at least equal to the accumulated earnings and profits.* (Italics Supplied).

It is clear from the foregoing authorities that the Court of Claims in restricting the rule requiring allocation of earnings and profits to cases where the old corporation has transferred *all* of its assets and liabilities has misconceived the scope of the *Sansome* rule, has materially weakened its application, and has thus created the conflict asserted herein.

2. The Court of Claims failed to apply the applicable Treasury Regulation

This Court observed in *Commissioner* v. *Munter, supra:*

> In *Sansome* v. *Commissioner* . . . it was held that implicit in the tax exemption of reorganization distributions was the understanding that the earnings and profits so exempt were acquired by the new corporation and were taxable as income to stockholders when subsequently distributed. Congress has repeatedly expressed its approval of the so-called *Sansome* rule as a correct interpretation of the purpose of the tax laws covering reorganizations. And Congress has apparently been satisfied with Treasury Regulations which follow the *Sansome* doctrine. [311 U.S. 210.]

The 1949 corporate reorganization here involved was admittedly a non-taxable transaction, and therefore no gain or loss was recognized. (Fdg. 8; R. 53). In such a situation Treasury Regulations 118, Sec. 39.115(a)-3(a) provide in part:

> If . . . in connection with a reorganization gain or loss was not recognized . . . then proper adjustment and allocation of the earnings or profits of the transferor *shall* be made as between the transferor and transferee corporations. (Italics Supplied).

It is submitted that the requirement of the Treasury Regulation is clearly mandatory and equally binding upon the Treasury and the taxpayer. Surely the regulation was not intended to apply only when it favors the Commissioner of Internal Revenue, or when only one type of tax-free reorganization is involved. However, these are the clear results of the holding below, and the decision thus conflicts with the principles announced by this Court in *Service* v. *Dulles, supra,* and *United States ex rel. Accardi* v. *Shaughnessy, supra.*

3. The court below erred in engrafting on the Sansome rule a requirement that precedent book entries must reflect an intent to allocate earnings and profits

It has long been established that book entries are inconclusive in the determination of tax liability. See *Helvering* v. *Midland Mutual Life Insurance Co.,* 300 U.S. 216 (1937) and *Commissioner* v. *F. J. Young Corp.,* 35 B.T.A. 860, aff'd 103 F. 2d 137 (C.C.A., 3d, 1939) where it was held that book entries to the surplus account capitalizing previous earnings will not in fact diminish the corporate earnings and profits available for dividends. Surely the corollary principle is equally true, i.e., the failure of the corporations involved in a tax-free reorganization to make book entries allocating earnings and profits pursuant to the *Sansome* rule and the Treasury regulations will not prevent the Treasury Department from requiring such allocation to be made for tax purposes.

In conflict with this well-established principle, however, the Court of Claims states that no allocation is required under the regulations or decided cases where:

(1) only a portion of the transferor's assets is transferred to the new corporation[3]

(2) where both corporations continue in existence[3]

(3) where the parties to the exchange did not, at the time of the exchange, intend or make any allocation, and

(4) the earnings and profits of the transferor corporation actually remain on the books of the transferor corporation after the exchange. (See pages 5, 11, and 12 of the Opinion below, R. 45, 51, 52).

It is thus apparent that considerable reliance is placed by the Court of Claims on the admitted failure of the two corporations involved in this case to make accounting entries on their respective books of record showing an allocation by them of the transferor's earnings and profits so as to evidence their intention to allocate. That such reliance is entirely misplaced and constitutes further error below is clearly shown by this Court's holding in *Commissioner* v. *Phipps, supra,* that:

> The *Sansome* rule itself, as applied to earnings and profits, has never been thought to be controlled by ordinary accounting concepts. [336 U.S. 410.]

To the same effect, see *Commissioner* v. *Wheeler,* 324 U.S. 524 (1945).

By placing such limitations on the application of the Treasury Regulation and the previous case law requiring an allocation of earnings and profits in a tax-free reorganization, it is respectfully submitted that the Court of Claims has made it possible for taxpayers through self-serving declarations of intent to avoid taxation of earnings and profits at ordinary income rates. For example, a taxpayer, owning all the outstanding stock of X Corporation with accumulated earnings and profits, causes X Corpora-

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[3] As to conditions (1) and (2), see Point I above.

tion to form a subsidiary Y Corporation to which X then transfers (1) only a part of its assets in exchange for all the capital stock of Y Corporation. Said stock is then held by X Corporation after which (2) both corporations continue in existence. The Board of Directors of the two corporations at the time of the exchange adopted resolutions stating (3) that they did not intend to make any allocation of X's earnings, and further issued instructions to the corporation's bookkeeper (4) not to make any accounting entries on X's books regarding surplus allocation.

Under the decision below, it would now seem that some time later the taxpayer could simply liquidate X Corporation through complete redemption of his stock and obtain its earnings and profits at capital gain rates,[4] after which he is entitled to hold the stock of Y Corporation so distributed to him without the burden of dividend potential from any allocated or "inherited" earnings and profits from X Corporation. It is submitted that this result emasculates the *Sansome* rule.

Finally, it is significant that, when viewed from the standpoint of economic benefit, the earnings and profits of Investment Company in the present case did *in fact* pass to the transferee, Motors Company, insofar as the concept of earnings and profits may be attributed to specific assets. And this is true whether or not any actual bookkeeping entry was made to reflect the fact. Thus, at the beginning of 1948, the original corporation (Investment Company) had an equity in its land and building of $134,662.26 which equity through borrowing thereon had been reduced by the end of 1948 to $124,581.87 (Jt. Ex. 2; R. 35). Since this real estate was the only asset of substance retained by the transferor, Investment Company, in the reorganization at January 1, 1949, it must

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[4] Under prior and present law, such complete redemption is not taxable as a dividend. See Treas. Regs. Sec. 39.115(g)-1(a)(2) and Treas. Regs. Sec. 1.302-4.

necessarily follow that this difference in equity in the real estate was in fact transferred to the new corporation (Motors Company) as a part of the inventory and operating assets transferred to the latter. The 1948 earnings and profits, therefore, did go to the new corporation,[5] and there is every reason to follow the Treasury Regulations which appear clearly to require that an allocation of earnings and profits in such a situation "shall be made."

CONCLUSION

In the light of the *Sansome* doctrine, as developed by the above cited cases and incorporated into the Treasury Regulations, it is respectfully submitted that the problem here involved is of considerable importance to the revenue. This Court accordingly should grant the writ of certiorari to settle the conflict between the lower courts and to make an authoritative determination regarding the scope and application of the *Sansome* rule.

Respectfully submitted

LLOYD FLETCHER
983 National Press Building
Washington 4, D. C.
Attorney for Petitioners.

SCOTT P. CRAMPTON
934 Bowen Building
Washington 5, D. C.
Of Counsel.

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[5] In stating as a part of Finding of Fact 9 that petitioners "do not contend that the $31,336.92 earnings and profits were actually transferred to Motors," it is believed that the Court of Claims overlooked the Supplemental Stipulation of Facts filed for the purpose of covering this point. (R. 31-40) The petitioners did contend in their Supplemental Brief below that the earnings and profits in question actually passed to the transferee corporation.

APPENDIX A

SECTION 112(b)(7), INTERNAL REVENUE CODE OF 1939 (58 Stat. 40, as amended):

(7) Election as to recognition of gain in certain corporate liquidations.—

(A) General Rule.—In the case of property distributed in complete liquidation of a domestic corporation, if—

(i) the liquidation is made in pursuance of a plan of liquidation adopted after December 31, 1950, whether the taxable year of the corporation began on, before, or after January 1, 1951; and

(ii) the distribution is a complete cancellation or redemption of all of the stock, and the transfer of all the property under the liquidation occurs within some one calendar month in 1951, 1952, or 1953—

then in the case of each qualified electing shareholder (as defined in subparagraph (C)) gain upon the shares owned by him at the time of the adoption of the plan of liquidation shall be recognized only to the extent provided in subparagraphs (E) and (F).

* * * * * * * * *

(E) Noncorporate Shareholders.—In the case of a qualified electing shareholder other than a corporation—

(i) There shall be recognized, and taxed as a dividend, so much of the gain as is not in excess of his ratable share of the earnings and profits of the corporation accumulated after February 28, 1913, such earnings and profits to be determined as of the close of the month in which the transfer in liquidation occurred under subparagraph (A)(ii), but without diminution by reason of distributions made during such month; but by including in the computation thereof all amounts accrued up to the date on which the transfer of all the property under the liquidation is completed; and

(ii) There shall be recognized, and taxed as short-term or long-term capital gain, as the case may be, so much of the remainder of the gain as is not in excess

of the amount by which the value of that portion of the assets received by him which consists of money, or of stock or securities acquired by the corporation after August 15, 1950, exceeds his ratable share of such earnings and profits. [26 U.S.C. § 112(b)(7), 1952 Ed.]

* * * * * * * * *

SECTION 115 OF THE INTERNAL REVENUE CODE OF 1939 (53 Stat. 46, as amended):

(a) Definition of Dividend.—The term "dividend" when used in this chapter (except in section 201 (c) (5), section 204 (c) (11) and section 207 (a) (2) and (b) (3) (where the reference is to dividends of insurance companies paid to policy holders)) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, * * *. [26 U.S.C. § 115(a), 1952 Ed.]

Treasury Regulations 118, Sec. 39.115(a)-3:

REG. 118, Sec. 39.115(a)-3. Effect on earnings and profits of certain tax-free exchanges and tax-free distributions.—

(a) If, under the law applicable to the year in which any transfer or exchange of property after February 28, 1913, was made (including transfers in connection with a reorganization or a complete liquidation under section 112(b)(6) and intercompany transfers of property during a period of affiliation), gain or loss was not recognized (or was recognized only to the extent of the property received other than that permitted by such law to be received without the recognition of gain), then proper adjustment and allocation of the earnings or profits of the transferor shall be made as between the transferor and transferee corporations.

(b) If a transaction described in paragraph (a) of this section has occurred, there shall be included in the accumulated earnings and profits of the transferee corporation as of the day on which such transaction occurred the proportionate part of any earnings and profits of the transferor corporation accumulated as

of such day and properly allocable to the transferee; and there shall be included in the current earnings and profits of the transferee for the taxable year of the transferee in which such transaction occurred the proportionate part of the earnings and profits of the transferor accumulated after the beginning of such taxable year and properly allocable to the transferee. The amount so included in the current earnings and profits of the transferee shall not exceed such proportionate part of the earnings and profits of the transferor accumulated as of the day on which such transaction occurred.

* * * * * * * * *

In the United States Court of Claims

No. 319-56

(Decided March 5, 1958)

MONTE MANSFIELD AND ELEANOR MANSFIELD v. THE UNITED STATES

Mr. Lloyd Fletcher for the plaintiffs. *Mr. Scott P. Crampton* was on the briefs.

Mr. George Willi, with whom was *Mr. Assistant Attorney General Charles K. Rice*, for the defendant. *Mr. James P. Garland* was on the brief.

LITTLETON, *Judge*, delivered the opinion of the court:

Plaintiffs brought this action to recover income taxes paid for the calendar year 1951 in the amount of $17,467.58 plus interest paid thereon together with interest on the total overpayment as required by law.[1]

The facts, undisputed by the parties, are as follows: Plaintiff Monte Mansfield operated a Ford automobile agency in Tucson, Arizona, as a sole proprietorship until January 1, 1948, at which time he formed a corporation ultimately known as the Monte Mansfield Investment Company, hereafter referred to as Investment. To this corporation he transferred all of the proprietorship assets, receiving in return substantially all of the corporation's capital stock except qualifying shares. This transaction was a tax-free exchange under section 112 (b) (5) of the Internal Revenue Code of

[1] Eleanor Mansfield is a plaintiff in this case merely because she and her husband filed a joint federal income tax return in 1951. These taxpayers keep their books and file their tax returns on cash receipts and disbursements basis by calendar years.

1939.[2] During 1948, Investment accumulated earnings and profits (earned surplus available for declaration of dividends) in the amount of $31,336.92. On January 1, 1949, the corporation entered into a tax-free exchange[3] with a newly formed subsidiary corporation, Monte Mansfield Motors, hereafter referred to as Motors. Under this reorganization, Investment transferred a portion of its assets and a portion of its liabilities to Motors in exchange for all of the issued and outstanding capital stock of Motors amounting to 312 shares having a par value of $100 a share, and representing the excess of the value of the portion of the assets of Investment transferred to Motors over the amount of the liabilities of Investment assumed by Motors in the amount of $31,224.10. (The excess of $24.10 contained in the net worth of Motors on January 1, 1949 was not sufficient to justify the issuance of another share of capital stock and was carried on the books of Motors as paid-in surplus.)

After the above described exchange of January 1, 1949, the assets of Investment consisted of the 312 shares of Motors capital stock, a building and fixtures therein, the land on which the building was located, and prepaid insurance on the building.

At the time of the above described exchange between Investment and Motors on January 1, 1949, the two corporations gave no thought to what disposition should be made of the $31,336.92 representing the 1948 earnings and profits of Investment, and the books and records of Investment after the

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[2] Section 112. "Recognition of gain or loss—

"(a) General rule. Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

"(b) Exchanges solely in kind—

"(5) Transfer to corporation controlled by transferor. No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange such person or persons are in control of the corporation; but in the case of an exchange by two or more persons this paragraph shall apply only if the amount of the stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange. * * *"

[3] Both plaintiffs and defendant regarded this transaction as tax-free, but differed as to the applicable section of the Internal Revenue Code. Plaintiffs considered this exchange as tax-free under the provisions of section 112 (b) (4), (g) (1) (D) and (g) (2) of the Internal Revenue Code of 1939. Defendant regarded and now regards that exchange as subject to the provisions of section 112 (b) (5) of the Internal Revenue Code of 1939 and therefore tax-free.

exchange on January 1, 1949 reflected an earned surplus of this exact amount. The books of the two corporations show no allocation of the $31,336.92 to assets transferred to Motors and those retained by Investment.

From 1949 to the middle of 1951 Motors earned substantial net incomes but paid no dividends to its sole stockholder, Investment. During this same period, Investment received from Motors rental payments constituting its sole source of income. On July 1, 1951, Investment was liquidated in a nontaxable exchange,[4] and plaintiff Monte Mansfield surrendered his Investment stock and received in return all of Investment's assets consisting of the land, building, and fixtures and the 312 shares of Motors capital stock..

Plaintiffs filed a joint federal tax return in 1951, electing under section 112 (b) (7) to postpone taxation of gain on the property received in the corporate liquidation of Investment by currently reporting their ratable share of Investment's earnings and profits as dividends taxable as ordinary income. Plaintiffs did not report as a dividend any part of Investment's $31,336.92 earnings and profits from 1948, reporting only the $1,572.37 accumulated by Investment subsequent to the creation of Motors, i. e., from January 1, 1949 to July 1, 1951.

The Commissioner of Internal Revenue determined that the earnings and profits of Investment taxable to plaintiffs as a dividend under section 115 of the Internal Revenue Code of 1939[5] consisted not only of the $1,572.37 earned by Investment subsequent to January 1, 1949 and reported by plaintiffs as a taxable dividend, but also consisted of the $31,336.92 earned by Investment in 1948 prior to the creation of Motors, and carried on the books of Investment as of January 1, 1949. In accordance with such determination, the Commissioner of Internal Revenue assessed a deficiency

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[4] This exchange was made pursuant to section 112 (b) (7) of the Internal Revenue Code of 1939.

[5] Section 115 of the Internal Revenue Code of 1939 in pertinent part reads as follows:

"The term 'dividend' * * * means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) *out of its earnings or profits* accumulated after February 28, 1913, or (2) *out of the earnings or profits* of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made. * * *" [Italics supplied.]

against the plaintiffs. They paid the deficiency asserted against them, filed a timely claim for refund, and instituted this action more than six months thereafter as provided by 3772 of the Internal Revenue Code of 1939.

In the instant suit [6] plaintiffs are not now claiming, as they apparently did in their tax return filed for 1951, that no part of Investment's $31,336.92 earnings and profits from 1948 were taxable to them as a dividend. Plaintiffs do contend, however, that the Commissioner erred in determining that the entire sum was taxable to them as a dividend. It is plaintiff's position that under applicable law they are entitled to allocate the 1948 earnings and profits of Investment between Investment and Motors for tax purposes. They do not contend that any such allocation was actually made at the time of the transfer by Investment of some of its assets and liabilities to Motors on January 1, 1949, or that the earnings and profits of $31,336.92 were, in whole or in part, actually transferred to Motors at any time. The plaintiffs concede that the books and records of Investment reflect earnings and profits of $31,336.92 as of January 1, 1949, but they contend that regardless of that fact there *must*, in this kind of transaction, be an allocation of those earnings and profits. In other words, plaintiffs say that, in this type of tax-free exchange, the law will presume an allocation whether or not, at the time of the exchange, one was made or intended.[7]

Plaintiffs base their argument for an allocation by operation of law on certain case law and a Treasury regulation which they claim provide for an allocation of earnings and profits in such a divisive reorganization or exchange. The plaintiffs assert that the "proper" method of making such allocation, in the instant case, is to allocate earnings to assets

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[6] This suit is based on two grounds: (1) that the Commissioner erroneously failed to make an allocation of surplus (earnings and profits) between the two corporations with the result that he overstated the available earnings and profits in Investment at the time of its liquidation in 1951 and (2) that the Commissioner understated the depreciation deduction on the improved real estate received by plaintiffs on said liquidation. The parties have agreed that the depreciation problem will be deferred and treated as a matter for consideration under Rule 38 (c), after the court has decided the allocation question.

[7] Under the plaintiffs' theory of the case, even if the corporate parties to the exchange on January 1, 1949 had intended to transfer the earnings and profits in their entirety to Motors, the applicable law, as interpreted by plaintiffs, would require that some of those earnings and profits be allocated back to Investment.

transferred and to those retained on the basis of their demonstrated earnings record, i. e. allocate the earnings to the asset which made the earning, which according to plaintiffs' theory would result in an allocation of $3,398.71 to Investment and $27,938.21 to Motors.

The Government takes the position that the amount of the parent corporation's earnings and profits available for distribution to its stockholders is unaffected by an exchange such as occurred between Investment and Motors in 1949, and that no allocation is required, because the net worth of Investment was not affected by the exchange in which Investment received back all of the capital stock of Motors. Alternatively, the Government urges that if the tax-free exchange of a portion of Investment's tangible business assets in return for Motors' stock does require an allocation of the transferor's previously accumulated earnings and profits, such allocation should be in proportion to the percentage of Investment's net book value of assets transferred compared to the net book value of those assets retained.

We are of the opinion that neither Treasury Regulation 118, section 39.115 (a)–3 (a), nor most of the cases relied upon by plaintiffs, require an allocation by operation of law of earnings and profits in a tax-free exchange where, as here, (1) only a portion of the transferor's assets is transferred to the new corporation in exchange for all of the capital stock of the new corporation (the capital stock of the new corporation went to the old corporation and not to the shareholders of the old corporation), (2) where both corporations continue in existence after the exchange, (3) where the parties to the exchange did not, at the time of the exchange, intend or indeed make any allocation and (4) the earnings and profits of the transferor corporation actually remained on the books of that corporation after the exchange.

Treasury Regulation 118, section 39.115 (a)–3 (a) is not an absolute requirement for an allocation in all kinds of tax-free exchanges. We are of the opinion that the regulation merely requires a "proper" allocation once it is established that an allocation is necessary at all. Inasmuch as the regulation is a codification of the Internal Revenue Code section dealing with the effect of tax-free exchanges upon dividends,

as that section has been interpreted by the courts, we shall next consider the cases in point.

Most of the cases cited by plaintiffs can be distinguished by the fact that the transferor corporations involved therein transferred all of their assets to the transferee corporations, and the transferor corporations were simultaneously liquidated. In the instant case, as noted above, only part of the assets of the transferor corporation was transferred, and the transferor corporation was not liquidated at the time of the transfer nor as a part of the same transaction.

In *Commissioner* v. *Sansome*, 60 F. 2d 931 (2d Cir. 1932), *cert.* denied 287 U. S. 667, the taxpayer bought stock in corporation A which had accumulated earnings and profits. Corporation A subsequently transferred *all* of its assets and liabilities to the newly formed B corporation, and the stockholders in A corporation received five shares of B corporation's stock for each share of A with no change in the proportions of their holdings. At the time of the exchange corporation A was liquidated, and corporation B, making no profits while in operation, was liquidated two years later. The taxpayer did not report his liquidating distribution as a dividend but treated it as a return of capital. The court held that since no gain was recognized in the tax-free exchange two years earlier whereby B was created, the profits of A were earnings and profits of B, the successor corporation, and the distribution to the taxpayer was a distribution of dividends out of the earnings and profits of B corporation taxable as ordinary income.

As indicated above, the *Sansome* case can be distinguished from the instant case in several ways. In the *Sansome* case, *all* of the transferor corporation's assets were given to the transferee without receiving anything in return, whereas in the instant case only part of Investment's assets were transferred and all of the stock of the transferee corporation was received by Investment in exchange. The transferor corporation was completely liquidated in *Sansome*, but here Investment remained in operation as a going concern for two and a half years thereafter. Since *all* of the assets had been transferred and the transferor corporation liquidated in the *Sansome* case, the transferor's earnings and profits had to

go to the successor corporation or nowhere, whereas, in the instant case, there is no such necessity, because the earnings and profits can and did remain with the transferor. The type of allocation involved in the *Sansome* case was a choice of whether or not the earnings would go to the surviving corporation or disappear altogether, but the type of allocation urged upon us by plaintiffs is a dividing up of profits between two existing corporations by operation of law. We think this is an erroneous theory.

In the *Sansome* case, the stockholders in the original corporation became, as a result of the tax-free exchange, the stockholders in the successor corporation, whereas in the instant case the stockholders of Investment remained the stockholders of Investment after the tax-free exchange on January 1, 1949, and their interest in Investment was unaffected by the 1949 tax-free exchange. It was Investment that became the sole stockholder of Motors. The instant case is not a situation where the stockholder has surrendered his stock in one corporation and received stock in another corporation. What has happened here is that Investment, as a result of the tax-free exchange of January 1, 1949, changed the composition of its assets and, in place of certain physical assets, it had after the 1949 exchange the 312 shares of Motors' stock which had a value identical to the assets transferred to Motors. The net worth of Investment was the same after the 1949 exchange as it was immediately prior thereto.

The *Sansome* rule has been applied to many different situations such as liquidations of a subsidiary by its parent, *Robinette* v. *Commissioner*, 148 F. 2d 513 (9th Cir. 1945), and mergers of two corporations to form a third, *Commissioner* v. *Munter*, 331 U. S. 210 (1947). In *Harter* v. *Helvering*, 79 F. 2d 12 (2d Cir. 1935), the *Sansome* rule was applied to permit a parent corporation, in absorbing its subsidiary, to deduct its own deficit from the earnings and profits inherited from its subsidiary in computing the amount of earnings available for distribution as dividends. The *Harter* result was not applied in *Commissioner* v. *Phipps*, 336 U. S. 410 (1949), where the liquidated subsidiaries had deficits instead of earnings and profits.

In the *Phipps* case, the parent corporation had earnings and profits out of which dividends could be declared, but the five wholly-owned subsidiaries which were merged into the parent in a tax-free liquidation had an aggregate net deficit. The parent company effected the tax-free liquidation of the subsidiaries by distributing to itself all the assets and liabilities of the subsidiaries and redeeming and cancelling the stock of the subsidiaries. The taxpayers (stockholders in the parent corporation) argued that the net losses of the subsidiaries should be deducted from the earnings and profits of the parent so that the distribution made to stockholders would be a return of capital and not a dividend taxable as ordinary income. However, the court held that the tax-free liquidation did not affect the earned surplus held by the parent corporation, and the pro rata cash distribution to parent's preferred stockholders was a dividend within the meaning of section 115 of the Internal Revenue Code of 1939.

The *Phipps* case would appear on first reading to be inconsistent with *Sansome* and *Harter*. But the apparently different treatment of a deficit situation in the *Phipps* case was explained by the Supreme Court on the ground of a different congressional policy toward losses, in that Congress had explicitly provided that the tax effects of losses should be deferred and that losses cannot be realized in the way that earnings are "realized". The Supreme Court, in the *Phipps* case, also explained its decision by stating that the rule of the *Sansome* case was not grounded on a theory of continuity of corporate enterprise but on the necessity to prevent the escape of earnings and profits from taxation. Earnings and profits, for tax purposes, are viewed as a tangible thing which cannot escape taxation by mere changes on accounting books.

Plaintiffs relied most heavily on the case of *Reed Drug Co.* v. *Commissioner*, 130 F. 2d 288 (6th Cir. 1942). The *Reed* case involved a situation where the parent corporation transferred *all* of its assets and liabilities to a subsidiary in exchange for all the capital stock of the subsidiary. Six months thereafter, the parent corporation was liquidated and at that time it distributed the shares of the subsidiary to its stockholders. At the time of its liquidation, the parent corporation claimed a "dividends paid credit" on the ground that such a distribution to its shareholders represented a

distribution of dividends out of earnings and profits. The court held that the parent corporation was not entitled to the "dividends paid credit" and that the earnings and profits of the parent corporation had gone to the surviving subsidiary corporation six months prior to the parent's liquidation, at the time of the exchange, citing *Sansome*.

The *Reed* case can be distinguished from the instant case in that in the *Reed* case *all* of the parent's assets and liabilities were transferred to the subsidiary at the time of the exchange, and, in the *Reed* case, the court found that, for all practical purposes, the liquidation of the parent corporation was part of the same transaction and simultaneous with the transfer of *all* of its assets and liabilities. Furthermore, the exchange in *Reed* was not a mere substitution of part of the assets of the parent for stock of the subsidiary, as in the instant case, because in *Reed* the shareholders of the parent became the shareholders of the subsidiary, whereas in the instant case the shareholders of the parent (Investment) continued to be the shareholders of the parent.

Although the *Phipps* case stated that the rationale of the *Sansome* case was the necessity to prevent the escape of earnings and profits from taxation and not the continuity of corporate enterprise, cases following the *Sansome* rule prior to the *Phipps* decision had frequently spoken in terms of continuity of corporate life. See *United States* v. *Kauffmann*, 62 F. 2d 1045 (9th Cir. 1933), and *Reed Drug Co.* v. *Commissioner*, *supra*. In the *Reed* case the court stated that:

> It is well settled that under the Revenue Statutes upon a nontaxable reorganization the accumulated profits or earned surplus of the liquidated corporation pass to the successor corporation with the same status and are available for the payment of dividends by the successor. Such corporate transactions limited to this extent do not break the continuity of the corporate life. [Citations omitted.]

Whether the rule of the *Sansome* case is based on continuity of corporate enterprise, as explained in the *Reed* case, or on the necessity to prevent escape of earnings and profits from taxation, as the *Phipps* case indicates, there is no reason to apply the rule to this case. Here, there is no

continuation of a single corporate venture in the *Sansome* sense, because both Investment and Motors continued in existence. There is no danger here of having the earnings and profits escape from taxation, as defendant fears, because taxes will be paid when the earnings and profits are ultimately distributed, and if we found that part of the earnings and profits should be allocated to Motors, those earnings would be taxed as dividends when ultimately distributed, even if Motors had not earned any profits itself, and in that event the taxation might be delayed but not escaped. Under either theory of *Sansome*, there is no reason to apply the rule here. The real reason for not applying the rule to the instant case, however, is that the rule does not extend to the situation now confronting this court.

In *Barnes* v. *United States*, 22 F. Supp. 282, we encounter a factual situation more closely resembling that in the instant case. In *Barnes*, the old corporation, in a tax-free reorganization, transferred only part of its net assets to the new corporation and the old corporation continued in existence for three years. The new corporation did not issue its capital stock to the old corporation as in the instant case, but to the shareholders of the old corporation. At the time of the exchange, the old corporation and the new corporation actually made an allocation of the earnings and profits of the old corporation between the two corporations. Three years later, the new corporation made a distribution to its stockholders part of which was from the earnings and profits which it had received from the old corporation at the time of the tax-free exchange. The stockholders of the new corporation contended that this distribution insofar as it represented earnings and profits of the old corporation was not taxable as a dividend, because it did not represent a distribution of the earnings and profits of the new corporation. The stockholders took the position that the distribution to them of the earnings and profits of the old corporation amounted to a return of capital of the new corporation. The court held that when part of the earnings and profits of the old corporation was transferred to the new corporation, they became earnings and profits of that new corporation and were available for distribution as dividends to the stockholders of the new corporation, and thus taxable to such stockholders

as dividends. The court reached this result not only on the basis of the facts of the case, which involved an actual transfer of such earnings and profits to the new corporation, but by extending the *Sansome* rule to a situation which the court conceded was different on the facts from *Sansome*.

In *Stella K. Mandell*, 5 T. C. 684, the old corporation transferred part of its net assets to the new corporation and continued in existence. The old corporation did not transfer or allocate any of its earnings and profits to the new corporation. In exchange for the net assets transferred to the new corporation, the old corporation received stocks and bonds of the new corporation which the old corporation immediately distributed to its shareholders, thus making its shareholders the shareholders in the new corporation. This resulted in a reduction in the net worth of the old corporation and also a reduction in the interest of the shareholders of the old corporation in such old corporation. Thereafter, the new corporation which had no earnings and profits of its own, made a distribution to its shareholders. The shareholders did not report the distribution as a dividend for tax purposes, but rather as a return of capital. The Tax Court held that under the *Sansome* rule it must be presumed that a proportionate amount of the earnings and profits of the old corporation followed those assets of the old corporation which were transferred to the new corporation and that the distribution to the shareholders of the new corporation was out of such earnings and profits of the old corporation which were now earnings and profits in the hands of the new corporation.

We do not think that the *Sansome* rule requires any such presumption and we would limit the application of the *Sansome* rule to cases in which the facts are identical or closely analogous with those in the *Sansome* case, i. e., where *all* of the assets and liabilities of the old corporation are transferred to the new corporation and where the old corporation is liquidated simultaneously with or as a part of the same transaction. We think that where less than all of the assets are transferred, the transferor corporation continues in existence, and no actual transfer of the earnings and profits of the transferor corporation is made to the new corporation, the rationale of the *Sansome* case is not appli-

cable and we can find no justification in law or under the facts of this case for presuming that a portion of such admittedly retained earnings and profits *must* have gone to the new corporation.

No part of the earnings and profits of Investment was actually transferred to Motors at the time of the tax-free exchange on January 1, 1949, and we are of the opinion that neither the case law nor the regulations require that, under the circumstances of this case, any allocation of such retained earnings and profits be deemed to have been made as between the two corporations.

Accordingly, since Investment made no distribution between January 1, 1949 and the date of liquidation in 1951, the distribution upon liquidation included the entire amount of earnings and profits of $31,336.92 retained by Investment, and this amount is taxable to plaintiffs as a dividend within the meaning of section 115 of the Internal Revenue Code of 1939. Plaintiffs are not entitled to recover on this claim, and as to it the petition is dismissed. The depreciation deduction problem will be considered in further proceedings pursuant to Rule 38 (c).

It is so ordered.

LARAMORE, *Judge;* MADDEN, *Judge;* WHITAKER, *Judge;* and JONES, *Chief Judge*, concur.

FINDINGS OF FACT

The court, having considered the evidence, the stipulation of the parties, and the briefs and arguments of counsel, makes findings of fact as follows:

1. Plaintiffs are husband and wife and reside in Tucson, Arizona.

2. Prior to 1948, plaintiff Monte Mansfield, as a sole proprietor, operated an agency in Tucson, Arizona, for the sale of Ford automobiles, parts, and services.

3. On January 1, 1948, plaintiffs formed Monte Mansfield Motors, a corporation chartered under the laws of Arizona, and transferred to it the Ford Agency business and the land and building owned by plaintiffs individually and used in the conduct of the proprietorship business. In exchange for these assets, plaintiffs received substantially all

of the stock of the corporation. On December 31, 1948, by an amendment to its corporate charter, the name of the corporation was changed to Monte Mansfield Investment Co.

4. The stock of the above corporation organized on January 1, 1948, was held throughout 1948 as follows:

	Shares
Monte Mansfield	1,256
Eleanor Mansfield	1
Monte Mansfield, Jr	1
Heath Wright	1
T. K. Shoenhair	1

The shares held by EleanorMansfield, Monte Mansfield, Jr., Heath Wright and T. K. Shoenhair were issued to them solely for the purpose of qualifying them to act as directors of the corporation. These stockholders endorsed their respective stock certificates in blank and Monte Mansfield was the actual and beneficial owner of the shares.

5. On January 1, 1949, Monte Mansfield Investment Co. had assets in excess of liabilities (including depreciation reserves) in the sum of $157,411.67, which includes accumulated earnings and profits of $31,336.92.

6. On January 1, 1949, plaintiffs organized a new corporation known as Monte Mansfield Motors as a subsidiary of Monte Mansfield Investment Company. The new corporation, hereinafter referred to as Motors, exchanged all of its issued and outstanding capital stock amounting to 312 shares, for certain assets of the parent company, Monte Mansfield Investment Co., hereinafter referred to as Investment. Motors also assumed certain liabilities of Investment. The amount of assets received by Motors in excess of the liabilities (including depreciation reserves) assumed from Investment, was $31,224.10.

7. At the time of the transfer of the assets of Investment to Motors, noted in finding 6, no allocation of earnings and profits was made between Investment and Motors although at that time Investment had accumulated earnings and profits of $31,336.92.

8. The exchange referred to in finding 6 between Investment and Motors, was considered by plaintiffs as tax-free under the provisions of section 112 (b) (4), (g) (1) (D) and (g) (2) of the Internal Revenue Code of 1939. De-

fendant regarded and now regards that exchange as subject to the provisions of section 112 (b) (5) of the Internal Revenue Code of 1939 and therefore tax-free.

9. As of January 1, 1949, after the exchange referred to in finding 6, the books and records of Monte Mansfield Investment Co. reflected the following assets, liabilities and earned surplus:

Assets	*Book value*
Land	$55,480.81
Building and fixtures	211,302.78
Prepaid insurance	1,605.70
312 shares of Monte Mansfield Motor Co stock.	
Liabilities	
Reserve for depreciation:	
Building and fixtures	5,905.08
Mortgages payable	136,296.64
Surplus	
Earned surplus	31,336.92

The following statement reflects the book value of both Monte Mansfield Investment Company and Monte Mansfield Motors after the exchange referred to in finding 6, with items segregated to show those transferred to Motors and those retained and received by Investment:

Assets		*Retained and received by Investment, transferor, Jan. 1, 1949*	*Received by Motors, transferee, Jan. 1, 1949*
Cash		----------	$8,175.65
Notes and accounts receivable		----------	32,662.01
Inventories of new and used cars, trucks, parts and materials		----------	90,362.62
Depreciable assets:			
Building	$211,302.78		
Less depreciation	5,905.08		
		$205,397.70	
Machinery and equipment	22,186.56		
Less depreciation	1,623.48		
			20,563.08
Office furniture and fixtures	19,503.67		
Less depreciation	664.28		
			18,839.39
Service cars	8,378.18		
Less depreciation	780.00		
			7,598.18
Land		55,480.81	

	Retained and received by Investment, transferor, Jan. 1, 1949	*Received by Motors, transferee, Jan. 1, 1949*
Assets		
Depreciable assets—Continued		
Prepaid insurance	$1, 605. 70	$400. 00
Investment in Motors Co. stock, 312 shares.	31, 224. 10	
Total assets	293, 708. 31	178, 600. 93
Liabilities		
Accounts payable	----------	12, 243. 05
Notes payable (less than 1 year):		
Monte Mansfield	----------	28, 082. 12
Other	----------	67, 329. 23
Mortgage notes payable, secured by land and building	136, 296. 64	
Accrued taxes:		
Personal property tax	----------	3, 545. 44
State sales tax	----------	2, 163. 94
Unemployment and FICA	----------	1, 334. 01
Federal and State income tax	----------	25, 875. 90
Withholding tax payable	----------	175. 80
Other accrued expense	----------	912. 57
Customer deposits	----------	3, 919. 80
Contingency reserves	----------	1, 794. 97
Total liabilities	136, 296. 64	147, 376. 83
Capital		
Capital stock	126, 000. 00	31, 200. 00
Paid-in surplus	74. 75	24. 10
Earned surplus (1948)	31, 336. 92	----------
	157, 411. 67	31, 224. 10

The land, building and fixtures listed above were the same assets that had been transferred to Investment, pursuant to the provisions of section 112 (b) (5), Internal Revenue Code of 1939, upon the formation of Investment on January 1, 1948.

The 312 shares of Motors, listed above, were retained by Investment until its liquidation in 1951.

Plaintiffs do not contend that the $31,336.92 earnings and profits were actually transferred to Motors, and the books and records of Investment, above, show that Investment retained the earnings and profits. Plaintiffs admit that, at the time of the 1949 tax-free exchange, they did not put their minds to the question of the $31,336.92. Except for the above

records and books, no proof has been offered as to what actually happened to the $31,336.92.

10. According to its books and records, Investment had net earnings after taxes of $1,572.37 for the period from January 1, 1949 to July 1, 1951, on which latter date Investment was liquidated.

During the period January 1, 1949 to July 1, 1951, Investment's only source of income was the building rent paid to it by its subsidiary, Motors, at an annual rate of $21,600.

11. On March 15, 1951, plaintiffs, as directors of Motors, determined an earnings experience of the assets retained by Investment after January 1, 1949. The earnings experience figure arrived at was $10,724.37 per annum before Federal income taxes, and this determination of earnings experience was made for the purpose of excess profits tax liability of Motors. The determination was never used in the calculation of the excess profits tax liability of Motors because a lesser tax liability was found to result from the use of a method of calculation not dependent upon the earnings experience of Investment.

12. Plaintiffs have determined that the profit and loss statement of Investment for the calendar year 1948 included (1) an assumed land and building rental income on assets thereafter retained by Investment in the amount of $18,345.72, based on the annual rent of $21,600 paid to Investment by its subsidiary, Motors, during the period 1949 through 1951, with appropriate adjustments for improvements, and (2) certain expenses totaling $14,043.30 assumed to be deductible from the assumed land and building rental income, as rental expense, resulting in a net income for 1948 of $4,302.42 upon which 1948 Federal income taxes of $903.51 were allocable. The balance of $3,398.71 represents the 1948 net earnings on said assets after taxes.

13. As of July 1, 1951, Investment was liquidated by plaintiffs and its assets were distributed to plaintiffs.

The unadjusted basis for Federal income tax purposes of the stock in Investment which was cancelled by plaintiffs in this liquidation, was $125,984.39.

The fair market value of the assets received by plaintiffs in this liquidation of Investment, less the liabilities assumed

by plaintiffs July 1, 1951, was $413,757.96, as shown in the following statement:

Assets		*Fair market values July 1, 1951*
Cash		$1,784.51
Land	$120,000.00	
Buildings	200,000.00	
		320,000.00
Capital stock of Motors (312 shares)		210,800.21
Prepaid items		2,004.45
Total assets		534,589.17
Liabilities		
Mortgage indebtedness on land and building	$111,697.84	
Miscellaneous liabilities	9,133.37	
		120,831.21
Net worth		413,757.96

14. In their 1951 Federal income tax return plaintiffs elected to treat the liquidation of Investment as a nontaxable exchange within the provisions of section 112 (b) (7) of the Internal Revenue Code of 1939. A part of the assets received by plaintiffs upon that liquidation was the 312 shares of Monte Mansfield Motors stock acquired by Investment in the exchange of January 1, 1949 when Motors, the subsidiary company, was organized.

15. During the years 1948 through 1951, no dividends were paid by either Investment or its subsidiary, Motors. Motors paid dividends to stockholders in 1952 aggregating $9,360, and in 1953 aggregating $9,360, during which years Motors' net income was $193,302.89 in 1952, and $114,129.32 in 1953. The reported net income and reported salaries paid to officers for Investment and for Motors during the years 1948 through 1951, inclusive, were as follows:

	1948	*1949*	*1950*	*1951*
Investment:				
Net income	$60,138.94	$2,276.28	$1,969.21	($190.63)
Salaries	41,050.00	None	None	None
Motors:				
Net income	----------	60,831.50	175,057.20	166,348.35
Salaries	----------	42,500.00	43,144.27	44,503.47

16. On July 1, 1951, the buildings acquired by plaintiffs upon the liquidation of Investment had a remaining useful life of 40 years.

17. Concerning the particular land and building acquired by plaintiff Monte Mansfield from Monte Mansfield Investment Company upon the liquidation of that company in July 1951, which property was thereafter leased by plaintiff Monte Mansfield to Monte Mansfield Motors, the following schedule reflects the income and expenses for the years 1951, 1952, 1953 and 1954, as reported by plaintiffs in their joint Federal income tax returns for those years:

1951		
Gross rents		$10,800.00
Expenses:		
Depreciation	$1,304.76	
Other expenses	4,200.74	
		5,505.50
Net rental profit		5,294.50
1952		
Gross rents		21,600.00
Expenses:		
Depreciation	2,609.53	
Mortgage interest	4,622.00	
Improvement bond interest	228.24	
Real property taxes	4,940.56	
Insurance	313.78	
		12,714.11
Net rental profit		8,885.89
1953		
Gross rents		21,600.00
Expenses:		
Depreciation	2,609.53	
Mortgage interest	4,462.12	
Improvement bond interest	190.22	
Real property taxes	4,747.89	
Insurance	1,440.26	
		13,450.02
Net rental profit		8,149.98

1954

Gross rents		$30,000.00
Expenses:		
Depreciation	$2,609.53	
Mortgage interest	10,640.14	
Improvement bond interest	133.16	
Real property taxes	4,840.20	
Insurance	1,008.84	
Attorney's fees	37.50	
Amortization of expense of securing new mortgage	178.08	
		19,447.45
Net rental profit		10,552.55

18. Upon examination of the return of the plaintiffs for 1951 the Commissioner of Internal Revenue determined a deficiency in the income taxes by including in the assets received on the liquidation all of the earned surplus of $31,336.92 which Investment earned in 1948.

19. Plaintiffs have exhausted their administrative remedies.

CONCLUSION OF LAW

Upon the foregoing findings of fact, which are made a part of the judgment herein, the court concludes as a matter of law that plaintiffs are not entitled to recover with respect to the allocation issue and the petition, in so far as it relates to the allocation question, is dismissed. The right of plaintiffs to recover and the amount of recovery, if any, with respect to the depreciation deduction issue will be determined pursuant to Rule 38 (c).